STATE OF CALIFORNIA

880.0670

STATE BOARD OF EQUALIZATION

0 N STREET, SACRAMENTO, CALIFORNIA

(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001)

February 10, 1988

Ms.

L

Dear Ms.

This is in response to your December 9, 1987, letter to Mr. of our Assessment Standards Division wherein you provided additional information in support of Torrance Memorial Hospital Medical Center's claims for the welfare exemption for its property at 3330 Lomita Boulevard, Torrance, for the 1985-86 through 1987-88 fiscal years; and you requested further review of the claims in light thereof. For the reasons hereinafter set forth, we remain of the opinion that portions of the Hospital's property are not eligible for the exemption.

The Assessment Standards Division's findings have been that portions of the Hospital's property leased to Health Access Systems (HAS) or to other for-profit corporations should not receive the exemption. In your letter, you stated that later "lessor-lessee" Agreements between the Hospital and HAS had been characterized as "owner-operator" Agreements and that HAS had become a limited partnership, and you described the Agreements thusly:

> ". . . A department of the Hospital which performs outpatient as well as inpatient services becomes the subject of a contractual "use" agreement. . . . Upon entering into such an agreement with the Hospital, HAS pays the Hospital a one-time flat fee equal to the current fair market value of the departmental contract as established by a competent, qualified appraiser. This value is reflective of the full value of the outpatient revenues generated by the department prior to its becoming subject to the agreement. As a result, HAS and its investors can derive benefit from the agreement only if utilization of the department increases above historic utilization levels.
>
> "After entering into the agreements, HAS forms joint ventures with physicians whose practice areas are related to the department under contract. By significant capital investment in these limited partnerships, the investing physicians furnish 50% of the capital necessary to purchase the contract from the Hospital. The remaining 50% is furnished by HAS, which assigns its interest in the

agreement for a 50% interest in the joint venture. Once the physician capital is raised, HAS assigns the entire contract to the limited partnership. Under the terms of the agreement, the partnership is obligated not only for payment of its portion of the one-time flat fee, but also for payment of a nominal monthly "use" fee, as well as for reimbursement to the Hospital of the fixed and variable costs of the department operations (which includes a management fee payable to the Hospital). In operation, therefore, the partnership bears a significant risk of loss if the utilization of the department decreases, and receives a financial incentive in the event revenue from nonprofessional billings of the outpatient services of the department exceeds expenses (including the management fee paid to the Hospital for its operation of the department) in the event utilization increases.

"The Hospital continues to own and operate the facility within the Hospital premises and under the license of the Hospital. Total management control resides in the Hospital. The patients who utilize the departments are Hospital patients. Because the Hospital continues to manage and operate the department, continues to use the department for inpatient and outpatient services and recoups both up front and on an ongoing basis the entire cost of operation, the agreements are not in any true sense a lease of any department or facility. Rather, they constitute a mechanism whereby the Hospital may compensate HAS and its joint venturers for the Hospital's use of capital furnished by the venturers and their increased participation in utilization of the Hospital."

Portions of the Hospital-HAS Corporation Agreement were set forth in my October 19, 1987, letter[1] to Mr. Craig Leach, the Hospital's Director of Finance. Corresponding provisions of the Hospital-HAS Limited Partnership Agreement which was included with your December 9 letter are as follows:

"OUTPATIENT CATHETERIZATION LABORATORY AGREEMENT

* * *

RECITALS

"A. The Hospital owns that certain facility located at 3330 Lomita Boulevard, Torrance, California . . . . The Hospital also owns the furniture, fixtures and equipment . . . .

[1]To the extent that my October 19 letter might be inconsistent with this letter, it is hereby superceded.

"B. Hospital desires to furnish, for the non-exclusive use of Operator, the Equipment and the Premises for use as the Hospital's outpatient catheterization laboratory (the 'Department') for the purpose of treating outpatients of the Department . . . .

"C. The Hospital and the Operator desire to enter into this Agreement pursuant to which the Operator will obtain the non-exclusive right to use the Premises and Equipment of the Hospital, ...

* * *

"1. The Use Agreement.

"1.1 Premises and the Equipment.

"The Hospital hereby grants to Operator and Operator receives from Hospital . . . (i) the Premises, and (ii) the Equipment . . . . The Hospital also grants to Operator a nonexclusive right in common with the Hospital to use the common areas and services of the Facility, . . . Operator acknowledges that it has thoroughly inspected and reviewed the Premises and Equipment and acknowledges that the Premises and Equipment are suitable for the purposes of Operator. Operator further acknowledges that it accepts the Premises 'AS IS' . . . .

"1.2 Term. The term of this use Agreement shall be for twenty (20) years, commencing on the 1st day of January, 1987, . . .

"1.3 Utilization Fee.

"1.3.1 Monthly Utilization Fee. Operator shall cause the Hospital to be paid, as a utilization fee for the Equipment and Premises, a monthly utilization fee in the amount of One Dollar ($1.00). . . .

* * *

"1.3.3 One Time Supplemental Utilization Fee Payment. In addition to the payments set forth . . . , Operator shall make a one time non-refundable payment to the Hospital in the amount of . . . ($515,000). Such one time supplemental utilization fee payment shall be a fee for the non-exclusive right to operate an outpatient catheterization laboratory.

* * *

"1.4 Use.

"1.4.1 Use. The Premises and the Equipment shall be used and occupied by the Operator only as the Hospital's outpatient catheterization laboratory and uses incidental thereto and for no other purposes. Operator shall not use the premises or the Equipment for any other purposes. The Equipment shall not be removed from the Premises without the Hospital's express prior written consent. Operator shall not use or occupy the Premises in violation of law or of the certificate of occupancy issued for the Facility and shall, immediately upon notice for the Hospital, discontinue any use of the Premises which is declared by any governmental authority having jurisdiction to be a violation of law or of said certificate of occupancy. Operator shall not do or permit anything to be done by others in or about the Premises which will in any way obstruct or interfere with the rights of other tenants or occupants. . . .

* * *

"1.4.4 Ownership and Inspection. The Equipment and the Premises shall at all times remain the property of the Hospital and no right, title or interest in the Premises or the Equipment shall pass to Operator except for the right to use the Premises and the Equipment during the term of this Use Agreement. Operator shall at all times during the term of this Use Agreement maintain, in good quality and in a visible location, labels on all Equipment, or distinct components thereof, which labels shall indicate that the Hospital is the owner thereof.

* * *

"1.7 Real and Personal Property Taxes

"1.7.1 Payment of Real Property Taxes. Operator shall pay, in addition to all other payments under this Use Agreement, all real property taxes, if any, applicable to the Operator's use of the Premises and the Equipment during the term of this Use Agreement.

* * *

"1.8.3 Change in Ownership. This Agreement shall immediately terminate on such date as not less than fifty percent (50%), on a cumulative basis during the term hereof, of Operator's limited partnership units (or any interest therein) owned by or held in the name of the original Limited Partners has been assigned or otherwise transferred to individuals or entities other than the original Limited Partners.

* * *

"2. Services.

"2.1 Services Provided by the Hospital. The Hospital shall, by itself or through agents or independent contractors, provide the following services in connection with Operator's use of the Premises and Equipment:

* * *

"3. Billing and Division of Revenue.

"3.1 Division of Hospital Charges. The non-professional billings for the Department shall be divided between the Hospital and Operator. Hospital shall be entitled to portions of the revenue sufficient to cover the Hospital's various expenses incurred in connection with operating the Department and providing services, overhead, supplies, the Premises, Equipment and related items under this Agreement, . . . Operator shall be entitled to the remaining revenue . . . .

* * *

"3.4 Books and Records. In order to verify the expenses, deductions, and allowances, as defined in Exhibit 'C' hereto, the Hospital shall maintain and keep books of account covering the expenses, charges and other costs incurred by it in connection with the provisions of services set forth in Sections 1 and 2.1 hereof. . . .

* * *

"4.2 Operation as a Department of the Hospital. The parties hereto intend that the Premises shall be operated as and shall be considered to be an outpatient department of the Hospital. Accordingly, in providing the services set forth in Section 2.1 hereof, the Hospital shall have the authority to take and may take such actions as are necessary to operate the Premises as an integral and subordinate part of the Hospital . . . .

* * *"

Also included with your December 9 letter were copies of September 13, 1984, and August 13, 1986, letters from the Internal Revenue Service to the Hospital stating, in part, as follows:

September 13, 1984, letter:

"This is in reply to your letter of June 29, 1984, . . . concerning your request for a ruling that neither your creation and investment in a for profit Corporation nor your participation in Corporation projects carried out with certain limited partnerships will jeopardize your exempt status under section 501(c)(3) of the Internal Revenue Code.

"For the purpose of maintaining or increasing the utilization of your various services, both inpatient and outpatient, . . . [y]ou will create a for profit Corporation that will provide medical support services through a wholly owned Service Corporation and will operate four of your outpatient departments through limited partnership.

"You will retain fifty percent of the stock of the Corporation and your staff physicians will be able to purchase the other half. . . .

"Four of your outpatient departments will be contracted to the Corporation which will create four limited partnerships to finance the operation of these departments. Corporation will retain fifty percent interest in each limited partnership and solicit investors for the remaining fifty percent. You will retain control of the departments through a management agreement and you, rather than the investors, will determine the rates to be charged. You will be paid a fee . . . for the contract. In addition, you will receive a management fee and be reimbursed for the fixed and variable costs of the individual department operations. Thus, the private investors benefit only if utilization of your facilities increase because, in effect, they only share in any profits over and above the level you currently receive.

* * *"

August 23, 1986, letter:

"This is in reply to letter of July 14, 1986, . . .

"For the purpose of maintaining or increasing the utilization of your various services, both inpatient and outpatient, . . . you propose to contract the operation of your remaining outpatient departments to a service corporation controlled by your parent entity Torrance Health Association. The service corporation will operate each of the outpatient departments as limited partnerships.

* * *

"Your remaining outpatient departments will be contracted to the Service Corporation which will create limited partnerships to finance the operation of each department. Corporation will retain fifty percent interest in each limited partnership and solicit investors for the remaining fifty percent. You will retain control of the departments through a management agreement and you, rather than the investors, will determine the rates to be charged. You will be paid a fee . . . for the contract. In addition, you will receive a management fee and be reimbursed for the fixed and variable costs of the individual department operations. Thus, the private investors benefit only if utilization of your facilities increase because, in effect, they only share in any profits over and above the level you currently receive.

* * *"

In this regard, we note that the Hospital has not previously forwarded copies of these letters to our Assessment Standards Division.

Revenue and Taxation Code section 214, which provides for the exemption, states that property used exclusively for religious, hospital, scientific, or charitable purposes owned and operated by community chests, funds, foundations, or corporations organized and operated for religious, hospital, scientific, or charitable purposes is exempt from taxation if certain requirements are met. Thus, the exemption is both an "ownership" and a "use" exemption, that is, for property to be granted the welfare exemption, an organization which meets all the requirements for exemption must own the property and the property must be used for qualifying purposes. If another organization also uses the property, both it and the owner must meet all the requirements for exemption, and the property must be used by both for qualifying purposes. In this latter regard, page 7 of Assessor's Handbook AH 267, Welfare Exemption, provides in pertinent part:

> "The property will not be exempt unless the owner and operator met the specific requirements of Section 214. Usually the owner and operator are one and the same, and the filing of one claim will suffice. Section 214 does not require that the owner and the operator of the property be the same legal entity, however, (Christ the Good Shepherd Lutheran Church v. Mathiesen, 81 Cal.App.3d 355); but if property is owned by one exempt organization and operated by another exempt organization, each must file a claim for exemption.

> "If the operator is not an exempt organization, the portion of the owner's property used by the operator is not eligible for the exemption. . . ."

And set forth on page 8 of the Handbook is the following example:

> "A qualifying organization, 'A', is the owner of 10 acres of land and a building used for qualifying religious purposes. . . . A nonqualifying organization, 'B', operates a preschool in a portion of the building in a private nonqualifying manner. Since 'B' (the operator) is not qualified, 'A' (the owner) does not receive an exemption on the portion of the property, building and land, used by 'B'. However, the remaining property, building and land, is exempt as it is used exclusively by a qualifying organization, 'A', for qualifying religious purposes."

As indicated, the ownership-operation/use requirement was considered by the court in Christ the Good Shepherd Lutheran Church v. Mathiesen, supra. Consistent with the above, the court held, among other things, that an owner of property may qualify for the exemption notwithstanding the fact that its property is leased to and operated/used by another organization, but that the property must be both owned and operated/used by welfare organizations in order to qualify therefor.

The operation/use requirement is not met in this instance since HAS, whether as a for-profit corporation or as a limited partnership, does not meet all the requirements for exemption and is using the property for other than hospital or charitable purposes, including revenue generating/sharing of net earnings purposes (Cf. section 214(a)(2)) and more advantageous pursuit of business or profession purposes (Cf. section 214(a)(4)). Such operation/use is recognized by the Agreements generally and also specifically in recitals B and C, and in paragraphs 1.1, 1.3.1, 1.4.1, 1.4.4, 1.7.1 and 2.1 thereof, and, based upon the Internal Revenue Service's September 13, 1984, and August 23, 1986, letters to the Hospital, presumably, by the Hospital itself in its June 29, 1984, and July 14, 1986, letters to the Internal Revenue Service seeking favorable rulings.

As to HAS as a limited partnership, as indicated, section 214 provides that property must be owned and operated/used by community chests, funds, foundations or corporations organized and operated for qualifying purposes. A limited partnership is not a community chest, fund, foundation or corporation.

Also, California Revised Limited Partnership Act is set forth in Title 2, Chapter 3 of the Corporations Code, sections 15511 through 15723. A limited partnership is a partnership formed by two or more persons under the laws of California and having one or more general partners and one or more limited partners (§ 15611(j)). Persons desiring to form such a partnership execute, acknowledge and file a certificate of limited partnership (§ 15621), share in the partnership profits (§ 15653), and, upon dissolution, may share in partnership assets/property (§ 15684).

Unlike the Hospital then, HAS would not meet all of the requirements of section 214:

1. It would not be a religious, hospital, or charitable organization. Cf. Section 214.

2. It would be organized and operated for profit. Cf. Section 214(1).

3. Net earnings could inure to the benefit of partners. Cf. Section 214(2).

4. Its property would not be irrevocably dedicated to exempt purposes, and upon dissolution, its property would not inure to the benefit of a qualifying organization organized and operated for exempt purposes. Cf. Sections 214(6) and 214.01.

5. It would not have a section 501(c)(3) or section 23701d tax letter to the effect that it would be exempt from federal or state income taxes. Cf. Section 214.8.

Accordingly, it is the operation/use requirement of section 214 as well as the requirements of section 214(a)(2) and 214(a)(4) that are at issue and that are, in our view, not met and incapable of being met under the circumstances. As indicated above, we do not agree that the property is used exclusively for hospital purposes by the Hospital (December 9 letter, p. 7), and Regulation 23701(d)(1) is inapplicable in this instance both because it is not a Board of Equalization regulation and because it does not address the question of operation/use of an organization's property by another organization (December 9 letter, pp. 7 and 8).

As to the requirement of section 214(a)(2) that no part of the net earnings of a qualifying organization inure to the benefit of any private shareholder or individual, similarly, Regulation 23701(b)(1)(A), which states, among other things, that "inurement means that an individual receives some special

benefit which is unreasonable under the circumstances because of his membership or relationship to the organization", is inapplicable since it is not a Board regulation; if applicable, it would, in our view, preclude the exemption since individual doctors are receiving net profits from the Hospital's Departments because of their relationship to and agreements with the Hospital; and if applicable, it would, in our view, constitute operation of the Hospital to serve private interests (Reg. 23701(b)(1)(A)(2)(v)). In this latter regard, we note that the examples of inurement referred to in Regulation 23701(b)(1)(A)(2) are exemplary only, not all inclusive.

As to the requirement of section 214(a)(4) that property not be used or operated by the owner or by any other person so as to benefit any shareholder, member, employee, or contributor of the owner or operator, or any other person, through the distribution of profits, payments of excessive charges or compensations or the more advantageous pursuit of their business or profession, while you state in your letter that "Hospital 'profits' are not distributed under the arrangements" (December 9 letter, p. 10), the facts are to the contrary. Section 3.1 of the Agreements states that the nonprofessional billings for the Department shall be divided between the Hospital and HAS, and that after specified payments of expenses, etc., HAS is entitled to any remaining revenue; the Hospital's June 4, 1987, letter to the Los Angeles County Assessor's Office states that HAS is entitled to the revenue stream from the outpatient portions of the Hospital; and the Internal Revenue Service's September 13, 1984, and August 23, 1986, letters to the Hospital, presumably, in response to the Hospital's June 29, 1984, and July 14, 1986, letters to it, state, among other things, that "the private investors . . . only share in any profits over and above the level you currently receive".

In our view, portions of the Hospital's property are clearly being operated/used to benefit HAS and the doctors through the distribution of profits and the more advantageous pursuit of their business/profession.

A further requirement is that of section 214(a)(3), that property be used for the actual operation of an exempt activity. Since portions of the property are operated/used by HAS and are used for revenue generating/sharing of net earnings purposes and for more advantageous pursuit of business or profession purposes, neither is this requirement met.

Finally, as to the letters from the Internal Revenue Service, the requirements for property taxation exemption purposes are both more numerous and more stringent than those for income

taxation exemption, since receipt of an income tax exemption letter is but one of such requirements for property taxation exemption (Rev. & Tax. Code, § 214.8), and since income tax exemption letters are issued primarily upon information submitted by the organizations seeking the exemption, with little, if any, independent investigation at the time of issuance.

Concerning the latter, per the September 13, 1984, Internal Revenue Service letter to the Hospital:

> "Based on the information submitted, and assuming the transactions will be as described, we have concluded that neither . . . will jeopardize your exempt status under section 501(c)(3) of the Code".

The August 23, 1986, letter is to the same effect.

Per the Court of Appeal in Alcoser v. San Diego County, 111 Cal.App.3d 907 in this regard:

> ". . . The [income tax] status conferred could only have been based on the self-serving tax-exempt purpose language of the trust agreement since the school had not then begun full operation. Further, no evidence was submitted to show what relevance the income tax exemptions given have to the right to the property tax exemptions requested here. If relevant at all, the letters are of insignificant evidentiary weight and would not affect the result of this case."

In conclusion, while you have stressed the objective of the Agreements and the effects/success thereof, for property tax exemption purposes it is, as indicated, whether the requirements for exemption are met that is determinative.

Very truly yours,

James K. McManigal, Jr.
Tax Counsel

JKM/rz

cc: Mr. [redacted]
Mr. [redacted]

bc: Mr. Gordon P. Adelman
Mr. Robert Gustafson
Mr. Verne Walton: We are returning the file herewith.
Ms. Colleen Dottarar: As you noted in the file, this is not a Rule 136 case.
DAS File
Legal

1309H